F-8410

ST. MARY'S UNIVERSITY SCHOOL OF LAW

CREDITOR'S RIGHTS — FINAL EXAM
Professor Richard E. Flint — Fall 1990

INSTRUCTIONS

1. This examination consists of three (3) questions on four (4) pages. Question 2 has two subparts. Question 3 has three subparts. Please make sure that you have all four pages. You have three hours to spend on the examination. Each question is weighted equally. Hence you should spend 60 minutes on each question.

2. Be sure to put your examination number on each book.

3. Do not write on both sides on the page. You must write legibly. Do not use pencils that are not sharp or pens that are nearly out of ink.

4. This examination is open book. You may refer to any written material you wish.

5. In answering each question, use judgement and common sense. Emphasize the issues that are most important. Do not spend too much time on easy or trivial issues at the expense of harder ones. If you do not know relevant facts or relevant legal doctrine, indicate what you do not know and why you need to know it. You must connect your knowledge of bankruptcy with the facts before you. Avoid lengthy and abstract summaries of general legal doctrine.

6. In each question, assume you are writing a memorandum for another lawyer in your firm. You are not in the position of an advocate. You must carefully assess both the weaknesses and strengths of your client's position.

I. (one hour)

Our client is Sam Spade. Last year he executed an agreed judgement with BancOne for $50,000 as a result of his inability to repay a promissory note. BancOne abstracted the judgement in Bexar county and in Nueces county. Sam is a musician who lives in a modest condominium in San Antonio which he purchased for $150,000 two years ago and which is subject to a lien of $145,000. He plays in two or three gigs a week and earned $50,000 last year. He is in financial difficulty because of a rather costly divorce that he went through several years ago. In that divorce he executed a document entitled "Property Settlement Agreement" under which terms he retained all the community property in return for paying his ex-wife $1,000 per month for the rest of her life. He has also executed contracts with two members of his band, guaranteeing them $3,000 per month each regardless of the income of the band. He has not paid his ex-wife or the band members for the last three months, and a prejudgment writ of garnishment was served yesterday on the bank where he maintains his only accounts. The bank called him to notify him that before the garnishment was served they had exercised their right to set-off his account because he owed them $5,000 on a note that was not yet due or in default. The note secured on band equipment worth $1,000. His mortgage company on his house has accelerated his note due it as result of his failure to make payments. If this was not enough trouble, he bought a new car last month, and his check for the down payment bounced and he received a call from them this morning that they wanted him to bring it back or they would begin hotcheck proceedings against him. He tells us that he never signed the security documents for the car, only an unsecured note. Finally, he notes that he filed a Chapter 13 several years ago and received a discharge after completing his plan; however, one of those creditors got real mad and Spade had to hit him with a bat to get him off his property. As a result there is pending a multimillion dollar lawsuit against him for malicious injury. He believes that he could fund a Chapter 13 plan from future gigs. Prepare a memorandum discussing the possibilities of his filing a Chapter 13 or 7 and the likelihood for complete success of both. Please identify what additional information that needs to be compiled before a final answer can be given.

(1) has he been putting $ aside on regular basis?
(2) any kids? Ct $ ordered, is paying child support?
(3) $ MV of condo?
(4) Amt owed on car? Value of car?

SEC 145,000 1000
NYSE 4000 ea 100

II. (one hour)

a. In a Chapter 7 bankruptcy case, Debtor elected his nonbankruptcy exemptions under § 522 (b)(2). The trustee seeks a court order requiring Debtor, ~~if and when he should sell any exempt property requiring Debtor,~~ if and when he should sell any exempt property following discharge, to notify the trustee prior to the sale. The basis for this is the trustee's assertion that, in most instances, nonbankruptcy exemption statutes exempt only specific property, and not proceeds. The trustee wants the chance to pursue those proceeds on behalf of the pre-bankruptcy claimants, if and when exempt property is sold. (a) If you were counsel for the trustee, how would you advance this argument? (b) If you were counsel for Debtor, how would you oppose it? (c) If you were a court considering this contention, how would you rule and why?

b. Debtor is a founder and Executive Vice President of Eggplant Computers, a successful computer company now four years old. Eggplant's stock is held by approximately 15 different people, all original investors or officers. In 1983, Debtor was granted a stock option with the following terms and conditions. The option covered 100,000 shares of Eggplant common stock. It was exercisable for a period of 45 days commencing with Debtor's fourth anniversary as an officer of Eggplant, an event that occurred on May 1, 1985. The exercise price was ten cents a share. The option is non-assignable, and specifies that any stock issued pursuant to it will have (in common with the rest of Eggplant's stock) restrictions on transfer unless and until a public offering is made of Eggplant common stock. not publicly held

Debtor filed a petition in bankruptcy under Chapter 7 on April 29, 1985. The trustee believes that the common stock is worth more than $20 a share and thinks he can sell it for that amount to Arthur Krock, a wealthy venture capitalist who has been looking for a way into Eggplant Computers. Discuss the bankruptcy law issues raised by these facts. (Assume there are no securities law issues.

III. (one hour)

A. Last year, the state bar association suspended David Drunker from law practice for an indefinite period. Drunker was an alcoholic and a compulsive gambler and was hopelessly in debt. He had tried to keep his head above water by doing legal services for retirees and charging them outrageous prices (such as $10,000 to write a simple will or process a Medicare claim). At the time of his suspension, he was told he could ask to have his license reinstated after a year and that heavy consideration would be given to the extent to which he had reimbursed or planned to reimburse the various widows he had overcharged. Drunker filed a Chapter 7 bankruptcy petition last November and has been granted a discharge. The bankruptcy court found that whatever claims the widows had against him fell outside the ambit of § 523(a) and hence were subject to discharge.

Drunker has asked the bar association to lift the suspension. In his petition he conceded that he had not paid back any of the widows and did not plan to do so. He argues, however, that the bankruptcy discharge makes this factor one that the bar may not consider it in deliberations. Please advise the state bar as to the merits of Drunker's argument.

B. Bank made $50,000 loan to Debtor two years ago. It took an interest in all of Debtor's personal property, securing the initial loan and any subsequent ones it made. Debtor was to make monthly installment payments of $2,000. Two months and a half months ago, Bank discovered that it had not filed its financing statement correctly. Bank immediately made a proper filing and renegotiated the original deal. It loaned an additional $5,000 to Debtor, also on a secured basis. Monthly installment payments were increased to $3,000. In a change from past practice, Debtor agreed to make its payments in the form of a cashier's check that was to be hand delivered to Bank on the first of every month. Three such payments were made before Debtor filed its bankruptcy petition. Can Bank keep any or all of the installment payments Debtor has made? To what extent will its security interest in Debtor's assets be enforceable in bankruptcy?

C. Debtor runs a garden supply store. It has about 25 different suppliers. As of the moment, Debtor owes a total of about $25,000 to 22 of the suppliers. Most of the $25,000 has been owing for more than 30 days. The suppliers request payments within 30 days and charge interest for late payments. Over the past several years, Debtor has usually fallen behind during the winter months when business was slow, but most suppliers were content to let the interest accumulate and wait until spring. Some suppliers would write and ask Debtor why payment was late, but even these were satisfied when Debtor explained that it was waiting for business to pick up in the spring. Debtor owes more this year than in past

I.

I will discuss each of Spode's liabilities and assets, determing what would occur in filing Ch. 7 or Ch 13.

First, Spode meets the requirement to filing Ch 7 because he is not one of the §109(b) exceptions. He also appears to meet the Ch 13 requirements because he is an individual with regular income with a secured, non contingent liquidated debt of no less than $350,000 and less than $100,000 of unsecured ~~non~~ non contingent liquidated debts. In this calculation, the multimillion dollar claim is not included because it is both contingent and unliquidated.

Apartment

The abstract in Belgen to clouds title to his condo. In Ch. 7, the obligation would be discharged, although in reality

it may be more difficult from trust to get the abstract removed, short of a lawsuit to try title lawsuit. In ch 13, the abstract would probably be considered an unsecured claim and to meet plan requirements, Spouse would have to pay no less to Bank One than it would have received in Ch. 7. Since there is a prior lien from the mortgagee on the property and the property is exempt in Ch 7, Bank One would receive nothing in Ch. 7. ~~Of the abstract~~

"Property Settlement"

Although titled a property settlement, this agreement really looks like alimony. This requires a state law determination. If it is a property settlement, the debt is discharged in Ch 7 and is a general unsecured claim in Ch. 13. If it is alimony, however, under §523(a)(5) it is a non dischargeable debt

in Ch 7 and under 1328(a) is nondischargeable in Ch. 13.

The contracts of band members are property of the estate under §541 but Spouse may not choose to assume or assign them under §365(c) because they are of the nature of personal services. This section applies to both Chapters. Spouse may not execute new contracts later to keep the band together to keep his regular income. The band members may be general unsecured creditors for any damages arising from the breach and would get whatever general unsecured creditors get in Ch 7 and no less than that in Ch 13.

It is not clear from the facts who filed a writ of garnishment. The creditor who filed it may be required to turn it over to the estate under §542 because

it may be a preference but the facts are not certain on this. The bank must turn over the amount they set-off.

The bank wrongfully exercised set-off because the obligation + them as garnishee was not in default. Default in the obligation triggers the right of set-off. The note they set-off is a $5,000 debt on property worth $1,000. Assuming there are no valuation issues that change this value, the bank in Ch. 7 has a secured claim for $1,000 and the remainder is a general unsecured claim. However, because they have a security interest in the boat equipment, the lien stays even if the debt is discharged. Thus, Spradlin must make payments to keep this from being foreclosed on.

Although in Ch. 13, the debtor keeps the property and the bank would have an allowed secured claim for the present value of the value of its security interest in the property and the plan must pay at least that much.

The default in the mortgage presents a problem for Ch. 7. Although as a homestead, it would be exempt property under the state exemption, if he cannot get current on the payments, the bank can foreclose ~~once~~ once the ch. 7 is over. Ch. 13 would allow him to fit the amount needed to cure into his 3 year to 5 with court approval) plan and keep the property.

~~The answer is~~ The seller of the car can bring a contract action against him and Spade if at

all possible should pay the amount of the check if he can, he can probably keep the car and the seller who was too dumb to get a security interest in a general unsecured creditor in Ch 7 or Ch. 13. Thus, the debt will be discharged and the seller will receive very little.

His prior chapter 13 does not prevent him filing here since he completed the plan. The tort suit ~~if~~ of Spade is found liable will be one of those 523 debts that the creditor can prevent a discharge from in Ch. ~~13~~ 7. However, in Ch 13, there is a super discharge that would allow that judgment to be discharged.

The other information we need is how soon the suit will be tried because if it becomes a non contingent,

liquidated claim, Spade won't be eligible for ch. 13. We must also find out if ~~he~~ he owns any property in Nemer County because it would not be exempt under Ch. 7. We need to know who garnished his account, for how much and why.

Recommendation — The pros for ch. 7 are ~~that~~ that it is less costly and it makes more debt disappear. He would also have the right of redemption, although that is not very applicable here without more facts about his personal property.

His problems with his mortgage ~~point~~ and the malicious tort seem point toward filing Ch. 13 to

Set the home at a value and cram down. The

negative is that Ch. 13 plans are rarely completed. He also must convince the court he has regular income, but that shouldn't be too hard since he made $50,000 last year. Perhaps the possibility of a huge nondischargeable tort judgment would provide the necessary dedication to his Ch. 13 payments.

DB

JL

II a. As trustee's ~~for~~ attorney I would argue assuming debtor is a Texas resident, using the Texas exemptions that there is no statute provision preventing this. The exemptions, at least those regarding personal property do not extend to proceeds. As trustee, he represents unsecured creditors who are one of the groups the Bankruptcy Code was created to protect. If state law doesn't exempt proceeds, why shouldn't a trustee be able to do his job by pursuing them? ~~Although~~ The Texas exemption specifically says in § 41.002 (4) that the proceeds of a sale of a homestead are not subject to garnishment for the six months before the sale. This indicates that after the 6

months, the protection is gone. Additionally, there is no such provision ~~for~~ for sale of exempt personal property. Since cash is non exempt, if debtor chooses to turn exempt property into non-exempt property, the creditors should have an avenue for satisfying their claims.

As attorney for debtor, I would argue that the trustee has no post bankruptcy powers at all to pursue these proceeds. His job is to protect the unsecured claims during bankruptcy, not post-discharge. Once the debtor has received a discharge, § 524(2) & (3) prevent any action to collect discharged debts.

This prevent actions against the debtor & his property. If trustee's argument ~~was~~ the law, the debtor would be locked into a situation where he must retain all exempt property or be threatened with a loss which was protected against in the Code. Such a ~~theory~~ theory would prevent debtor from receiving the "fresh start" Congress sought to provide for in enacting the Code. Under trustee's argument, there would not be a ~~time~~ point in time where the debtor knew he was free from obligations supposedly discharged in his Ch. 7. He could not sell exempt property to raise cash for any possible profit making ventures without possibly losing the proceeds to the trustee.

As the judge, I rule in favor of Debtor.

The spirit of the law of exemptions is that debtors are allowed certain property to allow them to get on with their lives, make their fresh start, and keep out of further financial trouble. The ~~so~~ cloud of debt would not lifted if the accepted trustee's argument and granted the court order. The trustee's job is limited to gathering ? preserving the property of the estate and liquidating and dividing the proceeds pro rata. Trustees job does not include monitoring ~~and~~ post bankruptcy transactions by the debtor + attempt to squeeze a drop of

blood from a turnip.

II b. The stock option appears to be a §365 executory contract and is thus §541 property of the estate. Since the option is open during the pendancy of the chapter 7, it may be assumed by the trustee if it is not considered a personal service K. Although the company may not want an outsider to purchase the stock, its non assignability clause is not valid under §365. The trustee may attempt to get court approval to assume the contract, by explaining that if there are sufficient assets in the estate to pay the 10¢ for the 100,000 shares, he can sell the shares for 200 times that

amount and thus increase the size of the estate tremendously.

The debtor will want to come up with a way to purchase these shares himself. ~~Since the~~ He will say that any property he acquires after the filing of bankruptcy is not property of the estate ~~like~~ unless it fits the § 541(a)(5) interests and this does not. The property acquired is the option, not the actual purchase. Because the option did not become property ~~of~~ until his 4th anniversary which was after the petition was filed, the option is not part of the § 541 pie. If he had died in time between filing and the anniversary, the

option would never have been available. Thus, this property is his, not the estate's. The debtor would probably beg, borrow & steal, not to mention sell all exempt property short of his favorite dog to raise the money to purchase this stock. Under this argument, if he can do so, he suddenly has a very nice bankroll that can't be touched by any pre-bankruptcy creditors.

III. A. To win in their attempts to get Drunker to straighten up and fly right, the state bar must show that its action in denying reinstatement of Drunker's license to practice law is not a discriminatory practice under § 525 of the bankruptcy Code.

The initial question which brings 525(a) into play is whether the state bar is a governmental unit. The bar could argue that it is just an organization of professionals, but this wouldn't fly since the state Supreme Court oversees the licensing of attorneys and the Committee notes following this section specifically state that a State bar association is one such entity conceived of in enacting the

legislation.

A stronger argument is that the statute prohibits refusal to grant or renew licenses "solely" because the person in question has been a debtor under the Code. The policy for this is to prevent outside threats from causing debtors not to file bankruptcy in situations where bankruptcy may be appropriate. The congress wanted to avoid the horrible stigma, and even quit using the term bankrupt to refer to such individuals.

To get around this section, the state bar must provide rational, valid reasons other than bankruptcy to deny the lifting of suspension. A

think such reasons can validly be argued:

to protect the already terrible public relations problems for lawyers. Of the general public ~~think~~ lawyers can cheat client and then discharge their debts in bankruptcy without any repercussions it will not be good for the profession. Further, attorneys in this state must establish they are of good moral character to be allowed a license in the first place. It seems that requiring an attorney to make amends for previous wrongs is a natural requirement in going along with the normal licensing process whether it is for an original license or a reinstatement.

The bar association may also not want him to benefit

from his wrongdoing. Further, if he is able to pull off such a scheme, other attorneys may be tempted to slide into such morally disgusting behavior. It would be an example to others if it is established that he can not get away with it.

For these reasons, I think the ban should be able to require repayment without being prevented by § 525. The real reasons are not his bankruptcy, but his moral character.

II B.

The bank is in trouble here. Under § 547 the while $0,000 may be an unsecured debt because of late perfection. § 547 allows the trustee to void transfers to or for a creditor, occurring 90 days before bankruptcy, while debtor was insolvent (presumed for 90 days before filing), for an antecedent debt that gives the creditor more than in a Ch. 7. ~~Because for~~ as the transaction is the granting of an interest in personal property. Although the money was advanced and presumably the documents signed 2 years ago, the under § 547 (e)(2)(B) a transfer occurs at time of perfection since it wasn't perfected

assuming
within 10 days. Thus the transfer, being the security interest, occuring 2 1/2 months before filing / it is not exactly clear from the facts if the 2 1/2 months "ago" is within 90 days (before filing) is for an antecedent debt. The debt arose 2 years ago. Thus this can be ~~a~~ avoided by the trustee, leaving the bank or unsecured creditor. Under 544(a) the trustee can strong arm creditors unperfected at time of filing and beat them in priority. This preference does not fit any of the exceptions because although it was maybe "meant" to be contemporaneous, under the rules of timing of transfers, the transfer occured 2 1/2 years after the debt arose.

in essence changing secured unperfected creditors to unsecure creditor

Being a secured creditor would place the creditor in a better position than unsecured creditors in / Ch. 7.

The three 3,000 payments are also preference, made to an unsecured creditor in 90 days before bankruptcy. There might be a timing problem here. If 3 payments have been made, it may be over 90 days since the bank perfected and the whole argument above fall through. Assuming the three payments, or at least 2 were made in the 90 days, unless they fit an exception they may be a preference. The only one arguable is the (c)(2) ordinary course of business exception. To win this and keep the payments,

Bank ~~must show~~ has the burden of proof to show that payments ~~of~~ debt were in the ordinary course of business, both between the actual parties and ordinarily in the business between banks and debtors and this bank and its other debtors. This is probably a tough one to try to prove since it is ~~for~~ not usually required that debtors only make payments by ~~the~~ cashier's check. Thus the bank probably cannot keep the 3 installment payments — all 3 if within 90 days, or at least 2 - I have already discussed above the enforceability of Bank's security interest under preference rules and the setoff provision. Another argument may be found in § 522(f)

that this is a non possessory non purchase money lien that can be ~~avoided~~ avoided to the extent it impairs his exemptions. The property is personal property but it's not clear if it is household furnishings and or the others (522(f)(2)(A)(B)(C)). If so, the trustee can attempt to invalidate the lien. This may not be available in Texas since one courts has ruled that such liens don't impair exemptions where the state exemption statute counts only the equity as the exemption. A similar case construing a Florida exemption statute is at the U.S. Supreme Court and this may open up this possibility in Texas if the court rules thus. If the ~~so~~ documents include

after required property clauses, such a provision is invalid in bankruptcy under §552.

III C.

An involuntary petition may be filed for a debtor when certain numbers ~~and~~ of creditor and amount of money requirements are met. The filing here appears to ~~be~~ satisfy §303 as follows: (b)(1) by 3 creditors, called "entities," unless the debtor has less than 12 creditors. Here, the creditor has over 12, so 3 must file and the aggregate amount of their ~~un~~ unsecured claim must be $5000. There may be an argument that since ~~a~~ one of these creditors "owns" the remaining two, it is really one creditor and thus a wrongful filing. However, case-

laws exist in support of the contention that separate corporations are separate creditors even if ~~not~~ closely related. Unless the whole board of directors and officers and stockholders are the same person, this is probably three creditors. In computing the amount, U.F. Co is owned 2,500 and UGT Co is owned 2,500 and thus the 5,000 requirement is met. U.S. Co is also owned money, although of the 10,000 it claims, the debtor will dispute for 8,000, ~~[redacted]~~ the amount, ~~[redacted]~~ is still sufficient assuming the 3 are found to be separate entities.

Having established the filing is valid, the court will have a hearing (if the debtor/ + money controverts)

to determine whether to commence or dismiss.

This case will rest on the determination of the requirement § 303(h)(1); whether the debtor is generally not paying his debts as they come due. The court will look at such factors as the timeliness of payments on past obligations (how long overdue is he?), the amount of debt long overdue, the amount of time during which debtor has not met large debts, loss of value of his assets and his general financial situation (is he solvent, is it mainly a "cash flow" problem?).

The debtor has some good argument here. He has not had a drop in value of asset, and his

late payments were a season behind, but were consistently paid and creditors were not foaming at the mouth. He has no real large debts and none that are way past due. The debts of 2 of the 3 that filed are not even debts yet owned, not county the amount in dispute is only 2-3,000 and is not long overdue. His general financial situation, while not where we'd all like to be is certainly not as bad as Donald Trump's. He is simply a check to check kind of operator that can probably get current on his obligations with some time to catch up during the up

season of a seasonal business. It is quite possible that the facts in this case would lead the court to dismiss the petition, which would allow debtor costs and reasonable atty's fees (is there such a thing?). If they were found in bad faith, he could also get proximately caused costs and punitive damages, although there is really no evidence of bad faith here.